

# AFA Monitoring Report

July – September 2012



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## INTRODUCTION

This report is the second report issued by FMA and follows on from the Interim Monitoring Report published on 1 July 2012 (found on FMA's website under: Keep Updated – Reports and Papers – AFA Interim Monitoring Report). This report includes FMA's monitoring of AFAs for the July to September 2012 quarter. Here we outline our monitoring activity, provide a snapshot of findings and explore some key themes.

We have also included a 'Helpful Information' section at the end of this report that provides answers to some of the questions we are frequently asked by AFAs during our monitoring visits and other interactions. Topics include:

- continuing professional development
- Code Standard 8
- dealing with offshore clients
- Anti-Money Laundering
- retirement and provision of educational seminars.

Appendix A provides information relating to the Interim Monitoring Report from September 2011 to June 2012.

### **Monitoring this quarter: Executive summary of our findings**

We continue to see many of the same issues that we reported in the Interim Monitoring Report. The most common issues we see are advisers having difficulty demonstrating adequate compliance with Code Standard 8. This standard requires AFAs to take reasonable steps to ensure the personalised service is suitable for the client. We are seeing AFAs failing to meet the elements of this Code Standard, for example by making reasonable inquiries to ensure they have an up-to-date understanding of the client's financial situation, financial needs, financial goals and tolerance for risk.

We comment further about this in the key themes section of this report. In light of these findings, we expect all AFAs to review their processes with reference to Code Standard 8, as well as the corresponding requirements to record aspects in writing under Code Standard 12.

In this report, we also point out issues we have seen with AFA's Primary Disclosure Statements. Schedule 1 provides the format required for Primary Disclosure Statements. Advisers should refrain from adding information not in Schedule 1, to their Primary Disclosure Statement.

We also discuss our thematic monitoring activities for next quarter.

# MONITORING ACTIVITY THIS QUARTER

Over the last quarter and since the publication of the Interim Monitoring Report, we have increased our monitoring activity in terms of frequency and the geographical areas covered. Our monitoring visits fall into one of the following three types of review:

## 1. Full monitoring visit

FMA conducts onsite visits to the AFA's place of business. This type of visit usually takes place over a full day. In a full monitoring visit the AFA has an opportunity to interact directly with FMA staff and demonstrate how they comply with the Code of Professional Conduct (the Code) for Authorised Financial Advisers. The process will typically involve the following:

- FMA reviews the AFA's records, including ABS, continuing professional development plan, record of CPD hours, complaints log and disclosure statements
- FMA invites the AFA to explain his or her process for providing financial advice, including the advice outcomes achieved for selected clients
- FMA reviews selected client files
- FMA provides feedback and seeks input from the AFA relating to any observations
- FMA provides a written report to the AFA following the visit outlining findings, any recommendations and any required actions
- After the AFA has an opportunity to review FMA's written report, the AFA has an opportunity to respond to FMA.

## 2. Verification visit

This type of visit typically involves less time than a full monitoring visit and is likely to last between two and four hours. In a verification visit, FMA reviews all of the same information and documents as indicated above with the exception of the client files.

## 3. Adviser business statement review

This type of review is a form of desk-based monitoring, which means FMA has not yet visited the adviser's place of business.

FMA requests the ABS from the AFA to review the adviser business and confirm compliance arrangements.

FMA compares the AFA's ABS with the requirements of the AFA Adviser Business Statement Guide. We may then write to the AFA to ask that he or she revise the ABS so that it more accurately reflects the nature of their business.

## Location of visits

This quarter	
August	Auckland - North Shore Auckland – City Central
September	Auckland - North Shore Rotorua/Taupo Christchurch

## Summary of visit findings

We conducted 28 visits during the quarter, involving 60 client files, as follows:

- 20 visits inclusive of client file reviews (full visits)
- eight visits exclusive of client file reviews (verification visits)

The number of observations relating to the Code:

Code Standard	Number of Observations
Standard 1	1
Standard 3	2
Standard 6	1
Standard 7	16
Standard 8	57
Standard 9	20
Standard 12	14

Of the 28 AFAs visited during this quarter, there were:

- seven instances where the disclosure statement was not in the prescribed format
- 13 instances where the disclosure statement did not contain all of the information required by the Financial Advisers (Disclosure) Regulations 2010
- five instances where the Monitoring team provided feedback relating to the AFA's compliance with the Standard Conditions for AFAs.

In a number of instances, failure to meet Code Standards 7, 8 and 9 may have been due to the AFA not recording the information. While we have highlighted that most issues relate to Code Standards 7, 8 and 9, inadequate record keeping (Code Standard 12) often means the AFA is not able to demonstrate their compliance with the other Code Standards.

## Summary of ABS findings

- 33 ABSs were reviewed this quarter
- 28 ABSs were reviewed as part of a monitoring visit
- five ABSs were reviewed this quarter, as a part of the desk-based monitoring review
- 21 AFAs are now making some amendments to the ABS, to better reflect the expected information.

The type of revisions that AFAs are requested to make to their ABSs include:

- clarifying business relationships of the AFA, for example, the AFA's business structure and who owns the business (business relationships)
- specifying contractual requirements that the AFA has with product Providers, for example, if the AFA has contractual requirements to exclusively use a product provider or place a certain percentage of business with the product provider(products and services)
- personalising the ABS to the individual AFA instead of describing the business entity that employs the AFA (role)
- describing the advice process more clearly (advice or service)
- disclosing potential conflicts of interest of the AFA (remuneration and reward)
- providing a breakdown of how the AFA is compensated (remuneration and reward).

# KEY THEMES

## Code Standard 8 observations

In our Interim Monitoring Report, we highlighted that Code Standard 8 compliance was an area of concern, and that we recognised in some instances enquiries may have been made by an AFA, but could not be demonstrated due to poor record keeping.

Under Code Standard 8, AFAS must make reasonable enquiries to ensure they have an up-to-date understanding of their client's financial situation, financial needs, financial goals and tolerance for risk, in regard to the nature of the personalised service being provided.

We also found that most AFAs generally use a Risk Tolerance Questionnaire (RTQ). However, there did not always appear to be a robust discussion between the client and AFA to clarify, for example, any inconsistencies in the client's answers, or to challenge the results of the RTQ where appropriate. Some AFAs simply asked the questions from the RTQ, recorded the results and matched clients to the asset allocations derived from the RTQ.

A robust discussion after completing the RTQ will uncover valuable information on the client's willingness to take risk and how they will react if their investment does not perform as hoped or expected. We consider that AFAs should not use an RTQ in isolation. Going beyond the RTQ to discuss the level of risk a client requires to achieve their goals, their risk capacity (client's ability to cope with a financial loss) and the client's perception of risk, will assist an AFA in developing a proper asset allocation for their client.

We are particularly concerned with AFAs failure to adequately demonstrate compliance with Code Standard 8. We highlighted this issue in our Interim Monitoring Report, and we now expect AFAs to review their processes with reference to Code Standard 8, and to ensure their suitability decisions are recorded in writing, as required by Code Standard 12.

We understand some AFAs may have interpreted the Code as requiring more paper work and record keeping than was intended, and therefore we have included some examples of the sort of matters an adviser might record in writing under Code Standard 12, including suitability enquiries under Code Standard 8. These are not intended to be 'one size fits all' examples, but should assist an adviser with some of the matters we would expect to see recorded:

- the goals, needs and objectives of the client
- the personal and financial circumstances of the client
- the risk profile of the client
- the advice
- why the advice was appropriate
- the advantages and disadvantages of the advice
- the consequences of replacing one product with another
- what the client should do next.

## Primary Disclosure

In our recent round of monitoring visits, we observed issues surrounding primary disclosure.

As a reminder, AFAs need to ensure they comply with Schedule 1 of the Financial Advisers (Disclosure) Regulations 2010. In particular, the following notes (extracted from the Disclosure regulations) on how to complete the primary disclosure are important:

- *include the same headings and words that appear in this form (other than the text that must be inserted or omitted, as detailed above)*
- *present the information in the same order as in this form*
- *don't include any information (other than unobtrusive material such as a corporate logo) that is not to be included in the disclosure statement*
- *include all tick boxes and the text relating to those tick boxes.*

We have seen advisers adding information about qualifications, specific products they sell and specific fees or commissions that they charge in the primary disclosure statement. The primary disclosure statement is heavily prescribed as to content and format and therefore additional information is not permitted in the primary disclosure statement. This makes it easier for consumers to compare the services being offered by different advisers. We have additional guidance on disclosure on our website at <http://www.fma.govt.nz/help-me-comply/financial-advisers/your-obligations/disclosure-obligations/#RfaDisclosureStatement>

Finally, when listing the financial adviser services that each AFA is authorised to provide under the heading, "What sort of adviser am I?" advisers should only list those services within their certificate of authorisation.

Financial adviser service scopes are:

- financial advice
- financial advice and investment planning services
- discretionary investment management services
- financial advice and discretionary investment management services
- financial advice, discretionary investment management services and investment planning services
- financial adviser services in relation to Category 2 Products only
- financial adviser services to wholesale clients and provision of class services.

These are the only services for which an AFA can be authorised, and therefore the only services which should be listed in the primary disclosure document.

## **Monitoring activity for the next quarter**

Our Monitoring programme during the first year has been designed on a locational basis. In future we will be introducing a thematic approach to our monitoring, which means location will not always be a sole determinant. One key theme is likely to be discretionary investment management services, with an emphasis on how this type of service is being delivered.

We will also apply the lessons learned from the issues recently raised in respect of problems with Ross Asset Management to recalibrate the risk setting we apply to selection of AFAs for monitoring.

Our focus is on helping willing compliers meet their obligations and best serve the objectives of the Act. We will only take action where we see serious or persistent misconduct. As well as being compliance focused, our monitoring visits are intended to be a two way exercise, where we can learn more about the industry we supervise and AFA's can learn more about our expectations.

We know that it is natural to be anxious before a monitoring visit, but we hope you will be reassured about the process when you read the feedback received from another AFA, below.

‘Thank you both for your courtesy and professionalism on the day. It made for a productive and worthwhile experience rather than a tense, acutely harrowing headmaster-pupil interview.’

At the conclusion of our monitoring, we also received a number of other encouraging comments from AFAs, with several reflecting on how the feedback has helped them to improve the service they provide their clients. We hope that you find the comments in our report of some assistance.

## HELPFUL INFORMATION

We have set out some examples of the types of questions asked by AFAs and an outline of our responses.

We have also included questions concerning:

- Continuing Professional Development (CPD)
- Risk Tolerance Questionnaires (RTQ)
- Dealing with offshore clients
- Anti-Money Laundering
- Retirement and provision of educational seminars

### CPD

AFAs must meet certain minimum standards for continuing professional training. These are set out in Code Standards 17 and 18 in the Code for AFAs.

The CPD requirements for AFAs are not prescribed in detail and do not specify content or value of credits or hours attributable to particular courses or learning. This is because the CPD requirements are intended to be as flexible as possible, to allow AFAs to direct their own learning and development. This approach was developed in close consultation with industry and professional bodies during the development of the Code.

The overarching principle of CPD is that AFAs must have the competence, knowledge and skills to provide services they are providing as required by code standard 14. Subject to that, they have discretion to undertake and structure professional training that best suits their individual needs.

AFAs should refer to the detail described in Code Standards 17 and 18, as well as the Code's competence requirements in Code Standards 6(a) and 14 to 16, including the overarching requirement of Code Standard 14 that states AFAs must have the competence, knowledge and skills to provide any financial adviser service

To summarise, if you are an AFA you should:

- identify the areas you need to focus on to improve your own competence, knowledge and skills in relation to your particular financial adviser services
- ensure the training you do maintains your competence at a level appropriate for the financial adviser services you provide or intend to provide
- ensure the training helps you keep up to date with developments relevant to your particular practice.

In making these assessments, you should bear in mind the following:

- a variety of subjects may qualify as CPD - provided that the training is relevant to your needs
- the degree of difficulty can also vary, again, as long as you are completing training that is relevant to your particular needs.

## What training is approved for CPD credits?

1. FMA does not 'approve' specific CPD credits.
2. Under the Code, an AFA is required as part of his or her continuing professional training to complete a minimum of 20 hours training within the CPD period. The training must comprise of at least 10 hours of 'structured' training. Completion of any structured training must be verified by the course provider or the AFA's employer and kept in the AFA's CPD log.
3. 'Structured' training is undefined under the Code except that it must be:
  - part of the requirements for a qualification on either the National Qualifications Framework
  - national register of quality assured qualifications
  - part of a structured continuing professional development programme managed by a DAO, or QFE or professional body (as defined in Schedule H of the Code).

This is a wide definition and should provide DAOs, QFEs and professional bodies with a good degree of flexibility to source and incorporate relevant training for their advisers, for example, they could incorporate overseas based training or materials as part of their programmes where there is no equivalent training available in New Zealand.

## When does the CPD period commence?

1. In most instances an AFA's CPD period will commence on the 1 January following the date an AFA becomes authorised. However, if an AFA has identified training that is necessary even if his or her CPD period has not yet begun, he or she is encouraged to complete the training.
2. AFAs should refer to FMA's website which provides comprehensive information about CPD: <http://www.fma.govt.nz/compliance/role/afas/your-on-going-obligations/continuing-professional-development/>

## Risk Tolerance Questionnaires (RTQs)

### What is our approach to RTQs?

1. At this stage FMA has not published any specific guidance on the use of risk profiling tools; however we are very conscious of the issues in our surveillance and monitoring of financial advisers.
2. The Code doesn't require the use of an RTQ or the use of a specific, industry-recognised tool. AFAs should not use a RTQ in isolation and should always ensure they have an understanding of the client's tolerance for risk, as provided in Code Standard 8. (Refer also to the section in this report where we talk about this.)
3. FMA will not generally question the methodology behind an RTQ. If FMA became concerned that the use of a particular RTQ was producing unsuitable outcomes for clients, then we would analyse this carefully in the context of Code Standard 8. Our focus is on whether or not the AFA

understands how to use the RTQ correctly and further questions around risk tolerance have been addressed if there are any inconsistencies in client responses.

## **Dealing with offshore clients**

### **Can I provide adviser services to overseas clients?**

1. The Financial Advisers Act applies to financial adviser services received by clients in New Zealand. It does not prevent New Zealand advisers providing services to overseas clients. Section 157(2) of the Act states that an adviser must comply with certain parts of the Act when dealing with clients residing in other countries.
2. However, most countries have their own regulatory regime and we recommend before providing any adviser services to overseas clients AFAs take steps to ensure they comply with local requirements and seek legal advice specific to their intended operations.
3. New Zealand AFAs are able to provide advice to Australian clients, with some exclusions. More helpful information is available on FMA's website. <http://www.fma.govt.nz/news/media-releases/trans-tasman-mutual-recognition-of-financial-advisers-announced/>

### **What are my responsibilities under the Anti-Money Laundering and Countering Financing of Terrorism Act (AML/CFT Act)?**

The AML/CFT Act comes into full effect on 30 June 2013. The Act sets out procedures that must be followed when handling client funds. Please refer to this link for more information on how the new rules will impact you: <http://www.fma.govt.nz/news/reports-and-papers/guide-for-small-financial-adviser-businesses/>.

## **Retirement and provision of educational seminars**

### **I am an adviser and I am planning to retire in the near future. What do I need to do?**

The AFA will need to notify FMA of his or her intention to terminate their authorisation and/or any other change in the AFA's circumstances as per the Standard Conditions of authorisation. [http://www.fma.govt.nz/media/690407/standard\\_conditions\\_for\\_authorized\\_financial\\_advisers\\_afas\\_incorporating\\_explanatory\\_notes.pdf](http://www.fma.govt.nz/media/690407/standard_conditions_for_authorized_financial_advisers_afas_incorporating_explanatory_notes.pdf)

### **Once I retire I want to provide workshops in retirement planning and financial literacy. How do I comply if I wish to remain an AFA?**

If the retiree remains authorised, the AFA will need to comply with all of the obligations as an AFA under the Financial Advisers Act, the Code, and the Standard Conditions in terms of the financial adviser services provided to clients.

## **What are my compliance obligations if I wish to terminate my AFA status prior to providing the services above?**

If the retiree decides to terminate his or her AFA status and is no longer registered as a financial adviser, the retiree would need to take care that any services provided are not covered by the Act and that this is clear to clients. For example, there are statutory exclusions for merely providing information (see section 10(3)(a)) and for making recommendations about a class of financial product, rather than a specific product (see section 10(3)(b)).

The retiree also needs to ensure he or she does not offer, or provide an investment planning service. Note, this does not require the recommendation of specific products (see section 11). There are offences for holding oneself out to be an investment planner without the appropriate authorisation and for providing services under the Act without being permitted to do so.

Alternatively, the retiree could remain registered, but not authorised as a financial adviser, in which case the retiree would be permitted to provide personalised advice on category 2 products or class advice on both category 1 and 2 products, but would not be permitted to offer or provide an investment planning service or provide personalised advice on category 1 products.

FMA's website contains comprehensive information about the different types of advisers, the types of advice they are able to provide and the relevant compliance obligations. Please see here: <http://www.fma.govt.nz/compliance/financial-advice/>

## APPENDIX A

### Update – Interim Monitoring Report September 2011 – June 2012

Over this period we conducted monitoring visits in the following regions.

Month	2011
Sept	Wellington and Lower Hut
Sept	Palmerston North
Month	2012
Feb/March	Tauranga
April	Invercargill
April/May	Queenstown

At the time of the Interim Monitoring Report we had not finalised our findings, but are now in a position to confirm the issues identified:

- number of clients files reviewed was 146
- number of client files with no issues was 35.

Code Standard	Number of Final Observations
Standard 1	1
Standard 6	35
Standard 7	23
Standard 8	78
Standard 9	40
Standard 12	33